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SUBJECT: LEBANON: CENTRAL BANK GOVERNOR PUSHES REFORM  
AMIDST RUIN

Classified By: Jeffrey D. Feltman, Ambassador. Reason: 1.4 (d)

Summary

1. (C) Central Bank Governor Salameh, who will attend the IMF/World Bank meetings in Singapore next week, took some credit for shepherding the Lebanese financial system through the recent war with minimal damage. He warned, however, of fiscal difficulties ahead as Lebanon comes to grips with a crushing debt burden worsened by the conflict. He proposed a transparent fund for reconstruction with donor participation and independent auditing. Salameh reported to us that the financial system is in good shape for now, but expressed pessimism regarding the political sphere and the potential for civil unrest. The March 2006 economic reform program will continue in broad outline, but the Middle East Airlines and other privatizations will have to be delayed to allow the recovery of their assets. End Summary.

Singapore Meetings

2. (U) On the eve of his departure for the IFI meetings in Singapore, Central Bank Governor Riad Salameh received the Ambassador and Polcouns on 9/14 for a briefing and discussion on the Lebanese economy and financial sector. Salameh will stay in Singapore until September 19 and will participate in the Core Group meeting as well as a bilat with USG officials on September 18. He is also planning to meet with the IMF, which will send a team to Lebanon in October. Salameh confirmed for us, as he will announce in Singapore, that he intended to adhere to the basic outline of the March 2006 economic reform program, with a delayed timeline on privatization.

A Reconstruction Fund to Reassure Donors

3. (SBU) Salameh explained to us his proposal for a development fund for Lebanon. Under his plan, the Fund would be created under Lebanese law but would seek donors to subscribe to the Fund as shareholders. The shareholders, which would include Lebanon's bilateral donors as well as the IMF and multilateral development banks, would elect a board by which it would exercise control over the Fund's

activities. The Board would also contract for independent audits of the Fund. In order to preserve sovereignty, the executive officers of the Fund would be Lebanese nationals.

¶4. (SBU) Salameh predicted that with such a Fund Lebanon could attract more capital than it is seeing now. Donors can use the Board instrument to place whatever conditionalities they wish on lending. This may prevent one problem Salameh fears -- that donor requirements for reform and other conditionalities may delay or prevent disbursement of funds such as those pledged at the Stockholm Conference.

¶5. (SBU) Political benefits might also be realized by using the Fund, Salameh suggested. The Siniora government is perceived as being Sunni-dominated and therefore generates suspicion among other groups when it spends money. Concentrating many reconstruction and development resources in the Fund could help to shield the GOL from accusations of corruption in disbursements.

¶6. (SBU) The Foreign Ministry has drafted legislation to create the Fund and presented it to the Council of Ministers.

The Governor confirmed for us that the reconstruction fund frequently mentioned by Prime Minister Siniora is the same Fund he is advocating, and responded favorably to the Ambassador's suggestion of using some of the \$300 million pledged by Kuwait and the \$500 million pledged by Saudi Arabia to seed the Fund.

#### Reconstruction Aid -- Early Disbursements

¶7. (SBU) The Governor reported that he met with the Saudi

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Finance Minister last weekend and secured a pledge to disburse the \$500 million Saudi pledge soon. The Saudis recently sent \$20 million for school expenditures.

¶8. (C) Salameh told us that the Prime Minister recently decided to retain control over reconstruction funds, rather than to turn it over to the Council for the South. Previous experience, according to Salameh, shows that the Council is likely to misallocate some funds and that funds legitimately spent will not produce any political benefit for the Siniora government.

¶9. (C) When asked by the Ambassador, the Governor said he had seen no sign of Hizballah spending on reconstruction. However, the private banks estimate that Hizballah has recently moved \$60-75 million into the country. That money must have been moved in cash, Salameh said, because the private banks are under reporting requirements for large transfers and in any case would have been unable to disguise them. Salameh concluded that Hizballah may have spent money on rents and direct payments for relief but had not spent large amounts on reconstruction. The total Hizballah has spent seems to be much lower than the publicity would suggest, Salameh concluded.

#### Financial Sector -- Stable for Now

¶10. (SBU) Salameh described for us a financial system that had kept its short-term stability during and after the Hizballah-Israel War. He noted that during the fighting he had constrained lending in pounds to tighten liquidity and limit dollarization, which climbed from 72% to 75%. The Bank lost \$2.5 billion in reserves and the financial system lost a similar amount in deposits, accounting for 3.5% of the whole.

Salameh compared the war with the crisis following Rafiq al-Hariri's assassination, in which dollarization climbed to 80% and deposits dropped by 2%.

¶11. (SBU) There is now more inflow of deposits than outflow, and even after the conflict Lebanon still has a net inflow of

capital for the past year. The country currently has a \$1 billion positive balance of payments, which is lower than estimates but still positive, perhaps surprising after the damage done to Lebanon's business activity during the war. Salameh predicted an uptick in consumer activity for the second half of 2006 but that activity would fall short of results for the first half of the year. All in all, the Bank is preparing for 2006 GDP growth at zero percent. The IMF is predicting 5% growth for 2007, which is lower than previous estimates.

¶12. (SBU) Direct losses to banks were on the order of \$300 million, the Central Bank has estimated, which Salameh characterized as not insurmountable. The banks can cover their losses with reserves and by changing the amortization of their real estate holdings. In addition, banks and commercial enterprises should be able to access medium-term credit through the International Finance Corporation and other IFI agencies directed to the private sector. Banks will end up with a profit for 2006 but it will be slightly less than predicted; Salameh said he told the banks, "you can't have a war and come out richer."

¶13. (SBU) Even with all the political tensions, the markets have been reassured by the Central Bank's governance through the crisis and by the promise of funds from Arab countries, as well as the supportive policies from the US and Europe. These factors may continue to help Lebanon recover. In addition, the mix of banking assets is not unhealthy -- one third each in government bonds, private lending and liquidity, and small exposure in eurobonds.

#### Trouble Ahead for Public Finances

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¶14. (SBU) While Salameh made a credible claim to have steered the financial system successfully through the crisis, he intimated that trouble lies ahead in the next few months.

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The GOL's budget deficit will be exacerbated by expenses related to the crisis. The government has not yet made allowances for the energy sector either; the drop in cheap fuel and electricity imports from Syria will add costs, in addition to the cost of rebuilding infrastructure damaged during the war.

¶15. (SBU) All in all, Salameh estimated, \$3 billion will have to be expended by the Central Bank to cover public debts. This is the time for the GOL to go to the markets to raise money, but a proposed law to allow borrowing in dollars will not be ready until after the reconvening of Parliament in mid-October. Even then, Salameh said, the law may be held hostage by Speaker Berri seeking funds for the Council of the South.

#### Debt Relief

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¶16. (SBU) Lebanon's debt is pushing 200 percent of GDP, according to Salameh, up from about 175 percent of GDP before the conflict. "Market debt" to private lenders is at \$26.5 billion approximately. These sums are manageable now, but will reach a "catastrophe" if something is not done to reverse Lebanon's growing debt trend within a few months. The large stock of debt is currently manageable, Salameh said, because the Bank managed to buy 23% of it without increasing inflation. The trick, he said, would be to buy back more of it when necessary without provoking massive inflation; and that may not be possible.

¶17. (SBU) Meanwhile, the GOL's deficit has reached 15% of GDP because of the war. Lebanon's economy is very sensitive, Salameh said, and government finances doubly so because they are built on customs and VAT. Central Bank net reserves are over \$3 billion, Salameh said, but a sum like that "could be

taken away in gas prices" should Lebanon begin subsidizing fuel.

¶18. (SBU) In answer to the Ambassador's question, Salameh said that he has not yet begun to focus on a possible Beirut I conference, but that he would like to see a date set by the end of the year. Before the war, Lebanon needed \$6 billion of debt relief and now needs \$10 billion, he added. Lebanon's preparation for the Paris II conference in 2002, in which Lebanon realized \$2 billion in relief, took two years or more to prepare.

Politics

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¶19. (C) Salameh, a Maronite who (like most prominent Maronites) has aspirations to the Presidency, expressed general support for the Siniora government "because there's no way to change it". He agreed that Siniora had come out of the recent crisis strengthened. He approached Michel Aoun for consultations during the time before Aoun's alliance with Hizballah and met with him and his economic advisors twice. However Aoun -- who, Salameh said, wants the Presidency to the exclusion of all else -- saw him as a competitor. Salameh convinced Aoun he was no threat and that is why, he says, Aoun does not attack the Central Bank.

¶20. (C) Salameh confided to us that he had met with Hizballah SYG Hassan Nasrallah in the spring and told him that Lebanon needs peace during the economically important period of June through September. Nasrallah replied that he understands the importance of "the people having money" and promised to remain business-friendly and not to stir up international trouble during the summer. The opposite, of course, happened, Salameh said, saying that he can't trust Nasrallah. Now all the emphasis is on bringing down the Siniora government, Salameh said. Lebanon can ill afford the kind of civil disturbance and turmoil that would accompany such a move.

Middle East Airlines

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¶21. (SBU) Privatization of a share of Middle East Airlines, which the Central Bank has held since a bank failure in the 1970's, has been put on hold until at least the end of 2006, Salameh said, in order for the airline's value to rise back to its prewar level. MEA lost \$20 million in the July-August period, whereas it usually makes \$44 million out of its yearly \$50 million profit during those two months. Clearly, the disruption of the summer's air traffic was a disaster for MEA. Despite its losses and imminent privatization, MEA will, under the Central Bank's guidance, have to make a decision in the next two months on replacing three leased Airbus A330s. MEA will tender for bids from Airbus and Boeing for replacements.

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